Before the
Federal Communications Commission
Washington, D.C.

In the Matter of	) WC Docket Nos. 10-90, 07-135, 05-337, and
Rate of Return Represcription	) 03-109
Staff Report	) GN Docket No. 09-51
	) CC Docket Nos. 96-45 and 01-92
	) WT Docket No. 10-208

COMMENTS
OF THE
RURAL TELEPHONE FINANCE COOPERATIVE

The Rural Telephone Finance Cooperative ("RTFC") hereby files its comments pursuant to the Federal Communications Commission's ("Commission") May 16, 2013 Staff Report regarding rate of return ("RoR") represcription, which initiated a proceeding to represcribe the authorized rate of return used to determine interstate common line rates and special access rates for rate of return incumbent Local Exchange Carriers ("LECs") and also used for some forms of support provided by the Universal Service Fund ("USF"), including High Cost Loop Support ("HCLS"), and Interstate Common Line Support ("ICLS").

As explained further herein, RTFC requests that the Commission defer represcribing the RLEC authorized RoR for two reasons: First, the Federal Reserve stimulus program is distorting financial yields, especially driving down the cost of debt.

Second, the Wireline Competition Bureau should search for methods of estimating rural local exchange carriers' ("RLECs") cost of capital that do not rely on using publicly traded proxy companies because the return and risk profile of these companies bear little resemblance to the financial, business, and regulatory challenges facing non-publicly traded RLECs.

I. <u>Description of RTFC and its Interest</u>

RTFC's exact name is Rural Telephone Finance Cooperative and its principal place of business is 20701 Cooperative Way, Dulles, Virginia, 20166.

RTFC is a private, not-for-profit cooperative association whose primary purpose is to meet the financial needs of its member telephone companies and cooperatives and their affiliated organizations. RTFC provides loan funds to the rural telecommunications industry at interest rates that are based primarily on RTFC's cost of funds and cost of operations. RTFC does not receive funding from the federal government and is not a Government Sponsored Enterprise ("GSE").

As of February 28, 2013, RTFC had approximately $500 million of loans outstanding to rural telecommunications companies and cooperatives, and more than $300 million in committed but unfunded loans to those entities.

II. The Current Authorized Rate of Return Should be Retained for RLECs

The Commission has noted that the current rate of return on equity is 11.25% and was set in 1990, and noted many changes in the market that have affected the rate of return. The Commission believes that the authorized rate of return may not be reflective of the true cost of capital. Indeed, by use of the Discounted Cash Flow Methodology ("DCF") and the Capital Assets Pricing Model ("CAPM"), the Commission's Staff estimates the "zone of reasonableness" to be 7.39% - 8.72% and suggests the Commission should use the upper half of the range 7.39% - 8.72% based on the weighted average of its calculations.

The application of the DCF and CAPM methodologies that rely upon short-term perspectives at a time when interest rates have been dramatically reduced by Federal Reserve policy designed to combat the Great Recession, which began in 2008, is likely to result in artificially low estimates of the true long-term cost of capital. Further, the telecommunications industry continues to evolve at a rapid pace and the risk profiles of land based service providers in general, and RLECs in particular, continue to increase.

The Commission's Staff has used proxy companies to represent RLECs. The Commission may have found certain similarities between larger industry players like predecessors to AT&T and Verizon and most RLECs when it initiated this practice in the

1990s or earlier, however such comparisons do not appear relevant today given how those companies have evolved and how their markets have changed.

In particular, formulas proposed by the Commission's Staff to evaluate RLECs may not be practical because RLECs are generally not publicly traded and their risk profiles may exceed those of companies like AT&T and Verizon. Indeed, as a lender into the RLEC market, RTFC questions whether the existing rate of return of 11.25% is adequate given the risk inherent in the rural telecom industry today.

III. <u>The FCC Should Defer Represcription of the Rate of Return</u>

The Federal Reserve's policies during the current Great Recession that began in 2008 have substantially reduced market interest rates. As the Federal Reserve has stated, the reduction in interest rates is intended as a temporary measure. Therefore, it is inappropriate to use them as a basis to establish a long-term measurement of capital cost.

Indeed, the DCF or CAPM methodologies presented in the Commission Staff's May 16, 2013 report rely on the current extremely low market rates of interest. Setting return policy based on the current low interest rate environment understates the true long-term cost of capital.

The Commission should also carefully weigh the changes in the telecommunication industry in recent decades. Wireless service is rapidly replacing traditional wireline service. Hence, the risk profile for the RLECs has substantially changed. This change has certainly invalidated comparisons between larger companies, like AT&T and Verizon which have transformed from RLEC-like operations in the early 1990's to become large and growing wired and wireless conglomerates. Regulatory uncertainty coupled with continued market and technology changes have led to a reduction in capital access for RLECs. The heightened risk profile of RLECs has led RTFC to apply tighter standards to its credit underwriting. The market acceptable debt level for RLECs is typically measured as a multiple of cash flow, or earnings before interest, taxes, depreciation and amortization ("EBITDA"). Given the level of uncertainty in recent years, RTFC's target maximum Debt-to-EBITDA for new financing transactions has generally declined from approximately 5.0:1 to around 3.5:1. Any reduction in the prescribed RoR will reduce the EBITDA of RLECs and lead to a reduction in the level of debt they can obtain. The reduction that has already taken place in the market with respect to the Debt-to-EBITDA level will be exasperated by a reduction in the prescribed RoR, as it will cause a reduction in EBITDA. Additionally, RTFC has seen a decrease in demand for debt capital during this period of uncertainty. RTFC believes that a reduction in the prescribed rate of return, as proposed, will further constrain capital access for RLECs and disincent capital investment by RLECs.

RTFC's member RLECs are small companies and cooperatives that are not publicly traded. Using debt and equity yields from publicly-traded companies is not appropriate for determining the cost of capital of these RLECs because substantial differences may exist between the risk profiles of the larger publicly traded RLECs and smaller RLECs.

IV. <u>The DCF Model</u>

The DCF method described in the May 16, 2013 staff report is one approach frequently used to estimate the cost of equity capital. While the DCF method may be applicable in many instances, it does not apply to RLECs whether privately held or cooperatively owned. These RLECs are not publicly traded and generally do not pay dividends. Hence a valuation model based on dividend growth is not meaningful.

The DCF method does not fit the privately held company or cooperative model because they are not publicly traded; hence, (1) a dividend yield does not generally exist, (2) a growth component does not fit the model, and (3) metrics for those market players which are publicly traded are not comparable to non-publicly traded RLECs, which may have substantially different risk profiles. Further, fixing the return on equity at a time when interest rates are at unprecedented low levels can have the effect of substantially understating the return on equity and subsequently the rate of return.

V. CAPM Analysis

The CAPM as presented in the May 16, 2013 staff report is a model that evaluates the relationship between risk and expected return and is typically used in the pricing of securities.

Like the DCF analysis, there are a large number of assumptions that are present when using the CAPM analysis, most particularly the use of publicly traded companies as proxies for RLECs. RLECs are privately held and are not generally available as portfolio assets for most investors. Inasmuch as most RLECs are privately owned companies and cooperatives and are typically not in the capital markets seeking to attract public investment, the use of the CAPM analysis is not appropriate.

VI. Conclusion

The provision of adequate and affordable telecommunications services to rural America, including broadband, cannot be accomplished and maintained without predictable and sufficient levels of support that will cover costs and incent capital investment.

While the FCC considers several approaches to incent broadband deployment to all Americans, it is important to consider access to capital as a key element in that effort.

Adjusting the rate of return downward today, under unprecedented capital market conditions and continued technological change and regulatory uncertainty, will certainly further constrict already-limited access to debt capital for most rural telecommunications service providers.

Therefore, RTFC requests that the FCC maintain the current 11.25 percent rate of return and not further impede capital access to rural telecommunications service providers.

Respectfully Submitted,

Rural Telephone Finance Cooperative

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